

***United States Court of Appeals  
for the Second Circuit***



**BRIEF FOR  
APPELLANT**



76-7156

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United States Court of Appeals

FOR THE SECOND CIRCUIT

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MILDRED GOLFAND, on behalf of herself and on behalf of  
AMERICAN INVESTORS FUND, INC.,

*Plaintiff and  
Cross-Appellant,*

—against—

CHESTNUTT CORPORATION,

*Defendant-Appellant,*

—and—

AMERICAN INVESTORS FUND, INC.,

*Nominal Defendant.*

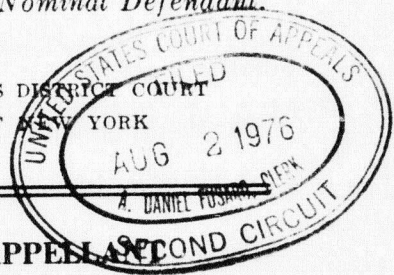
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ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF NEW YORK

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BRIEF FOR DEFENDANT-APPELLANT

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**BRIEF FOR DEFENDANT-APPELLANT**

Defendant appeals from a judgment of the Southern District of New York (Brieant, J.) awarding \$76,672 because of a false and misleading proxy statement. Plaintiff has cross-appealed and defendant is deemed appellant. A decision of the district Court denying an injunction is reported at 363 F. Supp. 291 (A-22) and the decision herein is reported at 402 F. Supp. 1318 (A-42).

**Statement of Issues Presented Pursuant  
to Rule 28 (a) F. R. Ap. Pr.**

1. Whether the first of three successive annual stockholder approvals is invalidated by inclusion in a proxy

statement of a true fact at the urging of the Securities and Exchange Commission, which true fact was concluded to be misleading by the trial judge.

2. Whether the subjective standard of "materiality" applied by the Court below is proper under § 14(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78n(a)) and § 20 (a) of the Investment Company Act of 1940 (15 U.S.C. § 80a-20(a)), and whether under any standard the proxy statement was false or misleading.

3. Whether plaintiff carried her affirmative burden of proving unfairness or unreasonableness under §§ 36 (b) or 47 (b) of the Investment Company Act of 1940 (15 U.S.C. 80a-35(b) and 80a-46(b)).

4. Whether there was any causal connection between claimed violation of § 15 of the Investment Company Act of 1940 (15 U.S.C. 80a-15) and approval by shareholders of an advisory contract.

5. Whether in any event plaintiff has shown any injury especially where the action taken by shareholders was prospective and plaintiff at all times could have declined to adhere to the new course of action by immediate redemption at net asset value without expense (i.e. "appraisal").

## Statement of the Case

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### Proceedings Below

Thrice times shareholder approval of an investment advisory agreement in 1973, in 1974 and again in 1975 was ignored by the Court below.

After trial without a jury, it held as a matter of law, and fixed money damage in November 1975, that it was false and misleading two years earlier in 1973 for a proxy statement to include true specific language at the urging of the SEC which the opinion characterized as "loose language on the part of a government employee" (A-53).

Further, the Court below held as a matter of law and without reference to the true and specific sentence on page 5 of the proxy statement dated June 21, 1973:

"Total net assets of the Fund were \$150,102,469 on June 14, 1973."

that it was false and misleading not to combine with another true statement

"... cost increases over which neither the Fund nor the Adviser can exercise control ..."

a judicial donation as to "... decreasing net asset value ..." already stated in specific dollar terms of \$150,102,469 above.

Such "false statements" voided shareholder approval (repeated in two successive years) of a contract that conformed the "expense ratio limitation" for federally mandated Fund housekeeping expenses (including transfer agent, postage, printing, etc.) to new California limits

which that State has extraterritorially imposed on federal investment companies.

Preliminarily, and after noting the directors had "frequently considered [the Fund's] rising expenses" \* the Court below held directors failed to fulfill their duty to inquire, though neither plaintiff nor the Court said what would or should be found out, and notwithstanding that the directors had ordered counsel to confer with officials in California and report between the two relevant meetings of the board of directors with respect to state regulatory policy, and notwithstanding specific consideration by the board of directors at a meeting of the comparative size and out-of-pocket expense of shareholder accounts of all twenty no-load funds having assets over \$100,000,000.

What the directors already knew, in "frequently consider [ing] . . . rising expenses" (A-49) and did not have to inquire about, had earlier been found by Judge Broderick (in denying an injunction) in Philadelphia (A-25) and disclosed in published annual reports showing:

" . . . that while the net assets of the Fund decreased by 15% during the period from 1967 to 1972, the Fund's expenses, *excluding the advisory fee*, increased by 70% or from \$508,340 to \$865,010." (emphasis added)

Finally, the Court below disregarded the Fund's calendar year filings with the SEC, calendar year accounting and reporting to shareholders, and the admittedly valid stockholder approval in 1974, and imposed liability for eight months of that year, as well as 1973 and entered judgment for \$76,672 (A-60).

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\* A-49.

### The Facts

The Court correctly found:

"The Fund and its Adviser had an established custom and practice of executing two year agreements which were replaced annually, a year prior to the expiration date." (A-46)

It was stipulated, but the Court did not find, that from inception in 1958 through 1974 the Fund's net asset value per share, including capital distributions, increased by 116.5%, or three times as much as the increase of 38.4% in the Dow Jones Industrial Average (stip. para. 26, A-37). The investment adviser prepares and sends to subscribers throughout the country and abroad, as well as to the directors of the Fund, a weekly market letter reflecting Chestnutt's technical analysis and general views. Chestnutt's letter dated May 16, 1973 sent to all directors prior to the directors meeting of May 21, 1973 stated

"In this case we believe we are in the final stages of an intermediate term decline that may already have bottomed but, if not, is about to end." (Exhibit F).

As a matter of fact, Chestnutt was correct. The June 14, 1973 value of the Fund of \$150,102,469 set forth in the proxy statement rapidly increased to \$174,000,000 at the end of October, 1973 (Exhibit 15). Had the net asset value continued at such level, the 1% expense ratio limitation would not have been exceeded. But upon the Arab oil embargo and the catastrophic market decline of November and December, 1973, the net asset value declined until September, 1974 when the Fund anticipated the general market by two months and commenced increasing in value (1974 Annual Report, Exhibit D, transmittal letter). Par-

enthetically, it might be added that while appreciation since that time has amounted to about 80% per share, this Fund, like the industry, continues to suffer heavy net redemptions.

Accordingly, Chestnutt's published expectation in May and June, 1973 that the market would appreciate, and the Fund with it, was a correct judgment, frustrated only by the wholly unforeseeable world-wide disruption of the oil embargo.

Pursuant to investment advisory contracts, the Fund paid defendant Chestnutt Corporation an advisory fee of 0.57% of average net assets for the year 1973 (Ex. 31, p. 21) and an advisory fee of 0.61% for 1974 (A. 194).

When the Fund was started the advisory agreement provided for a flat 1% per annum advisory fee as expressly permitted in Section 10 (d) of the Act, but in 1964 while the then existing agreement still had another year to run, the adviser proposed and Fund shareholders approved an agreement decreasing the rate of the annual fee to a sliding scale commencing at 0.8% on the first \$50 million of net assets, 0.6% on the next \$50 million and on a decreasing sliding scale on additional assets (A. 201-203).

In 1968, and again when the agreement had an additional year to run, the adviser proposed and Fund shareholders approved a fee schedule which increased the rate of the advisory fee at the lower end of the scale for large amounts of net assets and provided for an annual rate of 0.8% on the first \$50 million, 0.6% on the next \$50 million and 0.4% on the next \$200 million. (A. 201-206).

On December 31, 1972 the Fund had 110,800 shareholders (Ex. 14A, Ex. 14B). The direct cost of maintaining each shareholder account was about \$6, including annual charges

2% on the first \$10 million, 1½% on the next \$20 million and 1% in excess thereof. (A. 204-206)

Like all other amendments to the advisory contract, the limitation was inserted in 1967 in a new agreement while an existing agreement still had a year to run. (A. 203-205)

Exhibit B (pp. 2-3) discloses that the number of shareholders nearly doubled from 1967 to 1972, from 58,800 to 110,824, which at the direct cost of \$6 per account for 50,000 new shareholders, would amount to some \$300,000 of the increased expenses, clearly reflected in the 127% increase in transfer agent fees, the 32% increase in custodian fees, and the 136% increase in printing and postage for shareholder reports during the same period, reflected on Exhibit B (p. 3). This exhibit was ignored by the trial judge, but was the basis for Judge Broderick's finding of a 70% increase in expenses.

The directors are kept informed each week by written report of all Fund transactions during the week, subscriptions for shares and redemption of shares, together with a statement of the Fund's entire portfolio. The directors receive and examine quarterly and annual reports, and in each year have received the comprehensive annual report filed with the Securities and Exchange Commission. A portion of such annual report on Form N-1-R is the annual audited financial statement of the adviser, Chestnutt Corporation. (Depositions of all directors, entire Transcript) Thus, in April 1973 all directors had the audited statements of the adviser, as in all prior years. (Stip. ¶ 21, A-36)

In the light of knowledge gained through years of service on the board of directors (Stip. ¶ 9 A. 33) the directors in 1970 for the first time established a \$400 minimum initial purchase. (A. 122-123) At that time disinterested director Semmes had joined the Board and was familiar

by the Transfer Agent (which is a bank), printing, postage, etc. (A. 12, Ex. B). The Fund pays no salaries and pays no rent and all sales and promotion expenses of the Fund have been paid by the Adviser, Chestnutt Corporation, pursuant to contracts. (Ex. 1, Ex. 2)

There is no limitation under federal law as to the combined amount of advisory fees plus the expenses paid by an investment company, either in dollar amount or stated as a percentage (See e.g. § 10 (d), Stip., ¶ 1 A. 30). However, certain states have taken the position that they could restrict or limit such combined total of what the parties have referred to as "expense ratio limitation". In 1967, for the first time, the adviser proposed and shareholders approved insertion in the advisory agreement of an expense ratio limitation of 1% of the Fund's average net assets, which was the limitation which the State of California sought to impose upon investment companies selling shares to residents of that State. (A. 203-206)

Neither Pennsylvania where plaintiff resided when she bought 86 shares in interstate commerce nor New Jersey where she presently resides purports to have any such limitation. The direct \$6 cost per account at the Fund's low value of \$2.89 per share September 13, 1974 (Ex. D, Annual Report, p. 1) and the approximate \$4.00 per share value at the time of trial amounts to a direct expense ratio on her individual account of 1.7% to 2.4%, without any advisory fee whatever or any other allocable costs.

Subsequently California, as well as certain other states, amended their rule to provide for a 1½% expense ratio limitation on the first \$30 million and a 1% limit on the assets in excess thereof, and California has made a further amendment permitting the expense limitation ratio to be

with the minimum purchase as a means of reducing overall expenses to shareholders. (Stip. ¶ 9, A. 33 Ex. 34)

In 1971, disinterested Director Ulrich joined the board of directors, and the Fund commenced a program of redemption of small shareholdings, in accordance with the By-Laws, which first was fixed at less than five shareholdings. (Ex. 31, pp. 39-40, 37) In this connection and the directors' adoption of such a program, it was essential that the directors consider the matter of expenses and to the effect of the number of small shareholdings. (Ex. 14A, Ex. 14B, entire transcript)

In the spring of 1973 and prior to a meeting held May 21, 1973, the directors had received in connection with their annual and specific review of the Investment Advisory Agreement, copies of the Form N-1-R as filed with the SEC, including the audited report of the Adviser. (Stip. ¶ 21 A. 36) In addition, they had received copies of the "FUND-SCOPE" annual report of mutual funds consisting of a comprehensive volume of statistical data which seeks to describe the entire industry. (Ex. C)

During this time the inside directors, particularly Greene, were aware that an exhaustive report by the Investment Company Institute, a trade association, was being prepared at the express request of the California Corporation's Commissioner bearing upon the factors relating to expenses of investment companies. (Ex. 33, pp. 49-51) This report was NOT received by the Fund until late June, 1973, and accordingly was not examined by the directors prior to their June 5, 1973 meeting, but had been examined prior to the annual meeting. This report (Exhibit A) concludes that the principal element bearing upon the expense ratio of investment companies is the number of and proportion of small shareholdings and the conclusions therein expressed demonstrate that the experience

of the Fund and the views of its directors were the same as the experience of other investment companies.

No action was taken at the May 21, 1973 meeting with respect to the advisory agreement and counsel was directed to confer and did confer in person in the State of California with state officials. (Ex. 6, Ex. 8) Both opinions below quoted from Chestnutt's deposition taken in Philadelphia by plaintiff with respect to the remarks that he made to the Board of Directors on May 21, 1973. (A. 25; A. 51)

However wise and foresighted Chestnutt's deposition words of July 11, 1973 quoted by both courts, when the directors met again on June 5, 1975 they could not have predicted, after a prompt \$24 million appreciation, the stock market debacle which followed the oil embargo, accompanied by accelerated inflation throughout the world.

All the statutory "disinterested" directors were present on June 5, 1973. They were advised of the position taken by the State of California (Ex. 8) and reviewed data extracted by Director Ulrich (Exhibits 14A and 14B) which shows in tabular form the number of shareholder accounts of *all* no-load funds having assets in excess of \$100 million. The directors resolved to submit to the shareholders a proposal that the new investment advisory agreement to be entered into include a provision increasing the expense ratio limitation from 1% to 1½%. Their testimony is that this was done as a precautionary measure and in the light of a changed state rule. Indeed, the sharp improvement in the Fund's net asset position to \$174 million in ensuing months (Ex. 15) and until the Mideast War would, as a matter of arithmetic, have precluded any approach to the former 1% limitation, had not the stock market been devastated following the oil embargo.

Since at least as early as 1967 the directors have given continuous consideration to the question of Fund expenses; the Board was fully cognizant of the elements of such expenses; and the Board had taken particular and specific action with respect to such expenses in 1970 when the \$400 account minimum was established and in 1971 when the small shareholder redemption program was instituted. (Directors Depositions, entire Transcript) (A.-49)

Currier, with a dozen years of experience, although now redefined as an "interested person", managed a large corporate division with thousands of employees in several plants and holds a Harvard M.B.A. degree (Ex. 35). Fowler, a "disinterested" director of a dozen years experience, has run his own family business for years. (Ex. 32) Semmes, a "disinterested" director of four years experience in 1973 holds a law degree and ran his own business for years which had a volume of several million dollars. (Ex. 34) Ulrich, a "disinterested" director, with a Tuck School M.B.A. degree is peculiarly well qualified by reason of specific experience auditing investment companies and their advisers and major corporate responsibility in audit and control, and it was he who presented the specific analysis (Exhibit 14A and 14B) which the directors reviewed. (Ex. 36)

### **Certain Contradictory and "Clearly Erroneous" Findings**

While defendant submits the decision below must be reversed on its face, this Court should be fairly informed as to contradictory and clearly erroneous findings which could be corrected.

The Court below confused foresight with brinksmanship.

For example, the Court below (A-51) mistook a retained earnings figure of \$759,564 for the nearly same figure of \$754,759 of "*total current assets*", but failed to subtract current liabilities of \$484,802, nor even to mention the resulting *net* current assets of merely \$269,957 at December 31, 1972—appearing on the face of the same balance sheet (Ex. 2, p. 11) and furnished to the directors in April, 1973, and included in the proxy statement of June 21, 1973 to shareholders.

Nor did the Court mention the adviser's 1973 loss of \$248,000, plus the estimated loss of \$180,000—\$200,000 for 1974 (A-166-167).

On the same page (A-51) the Court quoted Chestnutt's July 11, 1973 testimony as to contingencies, and his statements:

"... expenses were going up and if contrarily the market kept going down it would be inevitable that *somewhere down the road*, if things didn't change, that it would reach the unfair proportions of perhaps bankrupting the adviser . . . that *way down the line* something like that could happen . . ."

and his further testimony almost a year later:

"... this is the sort of thing that if you don't plan ahead, you are dead and I didn't want to be dead."

The Court's conclusion that it was "likely" (A-47, A-48) that unfavorable market condition would continue and that a refund would be due conflicts with Chestnutt's statement published to the world (Ex. F), borne out with the prompt rise to \$174,000,000 in assets until the oil embargo, and the actual result for calendar 1973 of an expense ratio of merely 1.02%! (A-184, Ex. 13).

The Court paid no attention whatever to the importance of the specific, pointed study [Ex. 14A, Ex. 14B] relating to number and size of shareholder accounts—prepared and presented to the directors at their meeting June 5, 1973 by outside director Ulrich who had spent years with Arthur Andersen & Co. auditing *other* investment companies and supervised hundreds of financial employees at American Airlines as assistant Controller.

That Exhibit showed only one fund with more shareholders—T. Rowe Price with \$1,370,000,000 assets and 181,500 shareholder accounts—a fund almost seven times as large as this Fund with \$206,000,000 assets and 110,800 shareholders. The only other fund, Financial Industrial, approaching the number of shareholders had assets of \$327 million, or half more than the Fund here, but only about 75% as many shareholders (82,000).

This Exhibit 14A examined by directors before acting shows that the more effectively the Fund succeeded in serving the small investor the higher its direct expenses, and directly and specifically afforded the basis for their judgment.

### Damages

The Court's calculation of damages for the calendar year 1973, showing the 1.02% expense ratio, was \$18,330. (A-58) An accounting Regulation of the SEC (Reg. §270.2a-4b, 17 C.F.R. §270.2a-4b), provides that expenses of an investment company

“ . . . need not be so reflected if cumulatively, when netted, they do not amount to as much as 1 cent per outstanding share.”

One penny for each of a minimum of 29,000,000 shares outstanding during the period would require an expense swing of \$290,000 to be required to be reflected.

The amended California formula, which the shareholders have voted for three successive years to incorporate in the contract, provided for a flat increase of \$150,000 in allowable expenses by increasing the percentage from 1% of the first \$30 million to 1½% on that first \$30 million, or from \$300,000 to \$450,000.

The \$18,330 overrun for 1973 is less than a mill per each of the 29,000,000 shares, being calculated at 0.063% of one cent.

Expenses fell short of the 1½% limit approved by shareholders again in 1974 for that year by \$399,683 (A-168-170, also Exs. D and Ex E).

Plaintiff and cross-appellant urges a time period different from that required by filings with the SEC and mailings to shareholders, and the Court below found a still different 8 month/4 month period. Our reply brief will show that however the periods are dealt with, there is no refund due for all or any portion of 1974.

### Argument

The Court below held as a matter of law that the proxy statement (Exhibit 2) was false and misleading on its face.

In so concluding the Court stated (A-55):

"The quoted paragraph gives no indication whatever that a refund was ever even a remote possibility under any likely set of foreseeable circumstances including rejection of the proposed new agreement. In this regard, it was misleading, and false."

On the same page 6 of the proxy statement it was made clear that even the proposed 1½% limitation might be exceeded. The final sentence on that page is in a paragraph not quoted by the Court below and reads:

"However, no assurance can be given that the annual expense ratio will in fact be at a level less than 1½% of the average monthly assets."

The Court below took no cognizance whatever of the sentence:

"Total net assets of the Fund were \$150,102,469 on June 14, 1973." (Page 5 of proxy statement dated June 21, 1973, Exhibit 2)

The Court below took no cognizance whatever of Exhibit B, derived from published annual statements furnished all shareholders as well as, of course, to all directors, that charges mandated by federal statute, including postage, printing, bank charges, etc. *exclusive of any advisory fee whatever*, had increased by 70% in a 5 year period, or from \$508,340 to \$865,010, as found by Judge Broderick in denying the injunction (A-25), which injunction would in and of itself, have imposed additional expenses on the Fund for a new solicitation of some \$65,000 (A-27).

The Court below did not have before it the benefit of the Supreme Court's decision in *TSC Industries, Inc., et al. v. Northway, Inc.*, — U.S. —, 44 USLW 4852 (June 14, 1976).

The true statement of the actual total net assets of the Fund appears under the caption "Information Pertaining to Investment Adviser and Present Investment Advisory Agreement." That section immediately preceded the sec-

tion of the proxy statement, of which the Court below quoted only a single paragraph, captioned "Approval of the Terms of new Advisory Agreement."

The Court below employed precisely that erroneous legal standard rejected by the Supreme Court in *TSC Industries, Inc. supra*. The Court below adopted the standard (A-55, column 1) which found materiality to be that subjective and ephemeral thing:

"... in the sense that a reasonable investor might consider (it) important," (citations omitted).

For convenience we quote here the two paragraphs which we believe to be the crux of the *TSC Industries, Inc.* standard (44 USLW at 4855)

"We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. See *id.*, at 384. Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information—a result that is hardly conducive to informed decision making. Precisely these dangers are presented, we think, by the definition of a material fact adopted by the Court of Appeals in this case—a fact which a reasonable shareholder *might* consider important. We agree with Judge Friendly, speaking for the Court of Appeals in *Gerstle*, that the 'might' formulation is

'too suggestive of mere possibility, however unlikely.' 478 F. 2d, at 1302.

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills*' general description of materiality as a requirement that 'the defect have a significant *propensity* to affect the voting process.' It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The objective standard of the Supreme Court as to materiality is satisfied here.

Surely it is absurd that inclusion of a true statement at the instances of the SEC—"loose language on the part of a government employee"—can falsify the proxy statement.

The affirmative disclosure of "risk", which is quoted below, merely mentioned, but which the opinion below did not discuss, is entirely true and fairly presented the material facts to the shareholders. It stated:

"The Investment Advisory fee schedule would not be changed under the new agreement; however, the higher

allowable expense ratio limitation *would benefit the Adviser* by reducing the *risk* that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. (emphasis added)

This attempt to frustrate and overrule the three times affirmative decision of 100,000 shareholders of the body corporate is pursued by one whose expense burden for 86 shares (merely for transfer agent, postage, printing, etc.) far exceeds the present as well as the former expense ratio.

Not only is it absurd to suggest that multiple approval in corporate democracy may be overruled by mere conjecture—it is equally absurd to suggest that one having an immediate right of redemption (i.e., “appraisal” without any cost) may frustrate majority action as to the future.

As to the directors’ duties, it is sufficient to recognize that the directors being satisfied as to state regulatory matters, they then concentrated their attention at their second meeting on June 5, 1973, in pinpoint fashion and acted upon the basis of Exhibit 14A (typed in 14B) which specifically compared numbers and sizes of shareholder accounts and presented to the body corporate for action that which about six months later could be computed to cost about two-thirds of a mill per share—shares with an historical appreciation of 116% per share (thousands of times any additional expense per share, so small that the SEC’s accounting Regulation does not even require it to be “reflected” per share).

**CONCLUSION**

It is respectfully submitted that the judgment should be reversed and defendant should recover the costs and disbursements of the action.

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